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No. 95-1420

In the Supreme Court of the United States

OCTOBER TERM, 1995

PHILIP MORRIS INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the income realized upon the repayment of loans denominated in foreign currencies that results solely from favorable changes in foreign currency exchange rates—and not from any forgiveness of debt—constitutes income from the discharge of indebtedness within the meaning of Section 108 of the Internal Revenue Code, 26 U.S.C. 108 (1982), as in effect for taxable years prior to 1987.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-14a) is reported at 71 F.3d 1040. The opinion of the Tax Court (Pet. App. 18a-38a) is reported at 104 T.C. 61.

JURISDICTION

The judgment of the court of appeals was entered on December 8, 1995. The petition for a writ of certiorari was filed on March 6, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of Sections 108 and 1017 of the Internal Revenue Code, 26 U.S.C. 108, 1017 (1982), as in effect during the tax years involved in this case, are set forth at Appendix, *infra*, 1a-3a.

STATEMENT

1. Petitioner is a Virginia corporation. In 1980 and 1982, petitioner entered into several transactions in which it borrowed foreign currency from foreign lenders. Each of the loans was denominated in the foreign currency that was borrowed, not in U.S. dollars (Pet. App. 4a-7a, 19a-23a). In 1983 and 1984, petitioner repaid these borrowings in whole or in part, in each instance paying the full amount of foreign currency then due under the original terms of the loans. The lenders did not forgive any part of the debt or otherwise release taxpayer from its obligation to repay the full amount contractually owed (*id.* at 5a-7a, 20a-23a). Between the dates of the borrowings and the repayments, the foreign currencies in which the loans were denominated declined substantially in value against the dollar (*ibid.*). The difference between the dollar value of the foreign currencies on the borrowing dates and the cost in dollars of acquiring the foreign currencies used for repayment of the loans in 1983 was $20,908,319. For the loans repaid in 1984, this same difference was $897,352 (*ibid.*).

Petitioner acknowledges that the gains that it realized in 1983 and 1984 from the effect of the favorable exchange rate on its borrowing transactions represent income, and petitioner reported those amounts as income on its tax returns for those years. Petitioner took the position, however, that its gains

on the foreign loan transactions were income from the discharge of indebtedness that (i) may be excluded from gross income under Section 108(a)(1) of the Internal Revenue Code and (ii) is to be applied as a reduction of the basis of other property owned by petitioner under Section 1017 of the Code (Pet. App. 8a, 23a). The Commissioner disagreed and determined that deficiencies existed in petitioner's income taxes for 1983 and 1984. Petitioner sought review of the Commissioner's determination in the Tax Court (*ibid.*).

2. Petitioner contended that the issue presented in this case is controlled by *Kentucky & Indiana Terminal R.R.* v. *United States*, 330 F.2d 520 (1964), in which the Sixth Circuit held that repayment of a loan denominated in a foreign currency that had declined in value against the dollar resulted in income from the discharge of indebtedness that could be excluded from gross income under the predecessor of Section 108 (Pet. App. 31a-33a). The Tax Court agreed with the Commissioner, however, that, under this Court's decision in *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573 (1991), there was no income from the discharge of indebtedness within the meaning of Section 108 of the Code because none of the debt owed by petitioner was forgiven; instead, petitioner owed amounts of foreign currency that it repaid in full under the terms and conditions set forth in the loan agreements. The Tax Court held that income from the discharge of indebtedness arises under Section 108 only when a creditor accepts a performance that is less than the performance required by the original obligation (Pet. App. 35a) (emphasis added by court):

> We think the teaching of *Centennial Savings* is clear, namely that the discharge of an indebtedness may be the occasion for the realization of income but, unless there is a cancellation or forgiveness of a portion of the indebtedness not reflected in the terms of the indebtedness, such income is not realized "*by reason of the discharge* * * * of indebtedness of the taxpayer" * * * as required by section 108(a).

The court concluded that the interpretation of the term "income from the discharge of indebtedness" applied by the Sixth Circuit in *Kentucky & Indiana* was contrary to the interpretation of that term adopted by this Court in *Centennial Savings* and that the Sixth Circuit's decision had thus been effectively overruled (*id.* at 34a).

3. The court of appeals affirmed (Pet. App. 3a-14a). The court acknowledged that, under the Sixth Circuit's decision in *Kentucky & Indiana*, income of the type involved here would have been treated as income from the discharge of indebtedness (*id.* at 9a). The court of appeals agreed with the Commissioner, however, that this Court's decision in *Centennial Savings*, "while not expressly addressing foreign exchange transactions or the continued viability of *Kentucky & Indiana*, effectively undermined the latter decision" (*id.* at 11a). The court stated (*id.* at 13a):

> [W]e are not at liberty to entertain the taxpayer's position in light of the Supreme Court's clear holding in *Centennial Savings Bank* that Section 108(a) requires a forgiveness or release of an obligation of the underlying debt to constitute the

requisite discharge of indebtedness. 499 U.S. at 583.

ARGUMENT

The decision in this case correctly applies this Court's decision in *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573 (1991). Moreover, as petitioner acknowledges (Pet. 16-17 & n.3), Congress enacted significant revisions to the applicable statutory provisions in 1986. For all years after 1986, the question presented in this case is controlled by the specific language of these new provisions, which expressly require the same result reached by the court of appeals in this case. Further review of the decision in this case is therefore not warranted.

1. a. As in effect during the years involved in this case, Section 108 of the Internal Revenue Code provided that "[g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if * * * the indebtedness discharged is qualified business indebtedness" (26 U.S.C. 108(a)(1) (1982)). The statutory definition of "qualified business indebtedness" included "indebtedness * * * incurred or assumed * * * by a corporation" (26 U.S.C. 108(d)(4)(A) (1982)). A corporate taxpayer that desired to exclude income from the discharge of qualified business indebtedness from its gross income had to elect to reduce the basis of its depreciable property by the amount of the exclusion. 26 U.S.C. 108(c)(1), 108(d)(4)(B), 1017 (1982). As this Court explained in *Centennial Savings*, "the effect of § 108 is no genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the

taxpayer's annual depreciation deductions or by increasing the size of taxable gains upon ultimate disposition of the reduced-basis property." 499 U.S. at 580.

The question involved in *Centennial Savings* was whether the penalties that a savings and loan association charged its depositors upon the premature withdrawal of funds from certificate of deposit accounts constituted income from the discharge of indebtedness. The savings and loan association in *Centennial Savings* contended that any spread between the amount of the debt that it assumed upon opening a certificate of deposit account and the lesser amount that it paid the depositor upon early closure of the account was income from the discharge of indebtedness within the meaning of Section 108. 499 U.S. at 576-577. The Court rejected that contention, holding that income from the discharge of indebtedness occurs only when the creditor agrees to cancel or forgive all or part of the debt that was originally contracted. The Court explained (*id.* at 580-581 & n.6) (emphasis in part by the Court):

> As used in § 108, the term "discharge . . . of indebtedness" conveys *forgiveness of*, or *release from*, an obligation to repay.
>
> * * * * *
>
> "Discharge" can be used to signify various means of extinguishing a legal duty. See generally, Black's Law Dictionary 463 (6th ed. 1990). Thus, a debtor might be said to "discharge" his debt by satisfying it. But § 108 uses "income by reason of the discharge . . . of indebtedness" to refer to the change in the debtor's financial con-

> dition when the debtor is no longer legally required to satisfy his debt either in part or in full. *"Discharge" in this sense can occur only if the creditor cancels or forgives a repayment obligation.*

Although the depositor's premature withdrawal in *Centennial Savings* enabled the taxpayer to satisfy its certificate of deposit liabilities for less than the amounts that otherwise would have been due—thereby generating income for the taxpayer—the Court held that such income was not derived from the discharge of indebtedness because the penalty was one of the original terms of the deposit agreement. The taxpayer's receipt of income from such penalties "was not the product of the release of any obligation assumed by [the taxpayer] at the outset of the bank-depositor relationship" (499 U.S. at 581).

Under this Court's decision in *Centennial Savings*, in determining whether a taxpayer has realized "income by reason of the discharge * * * of indebtedness" within the meaning of Section 108 of the Code, it is not enough to consider whether the taxpayer's cost of repaying a debt is lower than the value of the proceeds originally borrowed. Instead, if the amount repaid by the borrower is the full amount required to be paid under the terms of the original loan agreement—as in the present case—there is no income from the discharge of indebtedness under Section 108. 499 U.S. at 581-583.

b. The court of appeals correctly applied the rule of *Centennial Savings* in holding that petitioner did not realize income from the discharge of indebtedness upon its repayment of the foreign currency loans involved in this case. Petitioner was not relieved of

any repayment obligation that it assumed when it entered into the loan transactions (Pet. App. 11a-14a, 32a-37a). To the contrary, it is undisputed that (i) petitioner borrowed a specific amount of funds in foreign currency, (ii) petitioner was, at all times, obligated to repay the full amount of the foreign currency that it had borrowed, and (iii) petitioner in fact repaid *in full* the amount of currency that it was obligated to repay under the original terms of the loan agreements.

To be sure, petitioner realized taxable gains from its foreign currency dealings: between the dates of the borrowings and the dates of repayment, the foreign currencies declined in value in relation to the dollar, and petitioner was therefore able to purchase the foreign currencies needed to repay its loans at a cost in dollars that was substantially less than the dollar value of those currencies at the time that they were borrowed (Pet. App. 5a-7a, 19a-23a). But the gain that petitioner realized was attributable solely to favorable fluctuations in currency exchange rates, not to any discharge of indebtedness. Because no part of petitioner's indebtedness was released or forgiven by its lenders, there was no income from the discharge of indebtedness within the meaning of Section 108. See *United States* v. *Centennial Savings Bank FSB*, 499 U.S. at 581.

2. Petitioner contends (Pet. 8-9) that the decision in this case conflicts with the decision of the Sixth Circuit in *Kentucky & Indiana Terminal R.R.* v. *United States*, 330 F.2d 520 (1964). That contention, while true, ignores the effect of this Court's intervening decision in *Centennial Savings*.

In the *Kentucky & Indiana* case, the Sixth Circuit held that repayment of a loan denominated in a foreign

currency that had declined in value as against the dollar resulted in income from the discharge of indebtedness within the meaning of the statutory predecessor of Section 108. That 1964 decision of the Sixth Circuit, which conflicts with the decision in this case, cannot be reconciled with this Court's 1991 holding in *Centennial Savings* that a "discharge" of indebtedness for purposes of Section 108 "can occur *only* if the creditor cancels or forgives a repayment obligation" (499 U.S. at 581 n.6) (emphasis added). As the court of appeals emphasized in this case (Pet. App. 11a), that holding of this Court in *Centennial Savings* necessarily overruled the Sixth Circuit's contrary interpretation of Section 108 in *Kentucky & Indiana*.

Petitioner asserts (Pet. 12, 16), however, that *Centennial Savings* did not involve foreign currency transactions and therefore is not applicable in the specific context of this case. But there is nothing in *Centennial Savings* to suggest that the Court's interpretation of the statutory term "discharge * * * of indebtedness" was limited to the particular facts of that case. To the contrary, the Court's holding that a "discharge" of indebtedness for purposes of Section 108 can occur *only* if the creditor cancels or forgives a portion of the original debt (499 U.S. at 581 n.6) necessarily applies to every case in which the meaning of that statutory term is at issue. It therefore applies—and governs—in this case, as the court of appeals correctly held (Pet. App. 11a-12a).

3. No conflict of decisions has arisen in the application of *Centennial Savings* to foreign currency borrowings. Petitioner nonetheless makes the unsupported assertion that the decision in *Centennial Savings* has created "uncertainty" (Pet. 9),

"enormous confusion" (Pet. 12), and "significant confusion" (Pet. 16) for the treatment of foreign currency borrowings. It is evident, however, that no genuine confusion or uncertainty exists. Certainly, the courts below were not confused: the Tax Court stated that "the teaching of *Centennial Savings* is clear" (Pet. App. 35a), and the court of appeals found no difficulty in interpreting the "clear holding in *Centennial Savings Bank*" or in applying that holding to the facts of this case (*id.* at 13a).

Petitioner exhibits its own confusion by relying on the legislative history of Section 108 of the Code as support for its position in this case. According to petitioner, this legislative history shows that petitioner is an intended beneficiary of Section 108 because Congress desired to permit solvent corporations "to repurchase their bonds at a discount on the open market without incurring immediate tax liability" (Pet. 13). But the "discount" to which the legislative history refers is an acquisition by a corporation of its own debt instruments at a price less than their par or face value. See *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931); *Colonial Savings Ass'n* v. *Commissioner*, 854 F.2d 1001, 1004-1005 (7th Cir. 1988), cert. denied, 489 U.S. 1090 (1989); H.R. Rep. No. 855, 76th Cong., 1st Sess. 7 (1939). By contrast, petitioner did not settle its foreign debts for less than, or otherwise at a discount from, their par or face amounts. Instead, it repaid the full amount of the borrowings in the foreign currencies in which the borrowings were denominated. Petitioner did not realize income by reason of a forgiveness or discounting of its debts. Instead, petitioner realized income from the fluctuation in value of the foreign currencies in which it transacted its business.

4. The question presented in this case lacks recurring importance due to the extensive revision of the applicable statutory provisions made by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. For taxable years beginning after 1986, the income tax consequences of foreign currency transactions such as those involved in this case are governed by a new provision of the Code (Section 988) under which foreign currency gain is expressly treated as ordinary income.* See § 1261(a), 100 Stat. 2585 (adding Section 988 of the Code). Moreover, Section 822(a) of the 1986 Act, 100 Stat. 2373, repealed any application of the discharge of indebtedness rules of Section 108 to qualified business indebtedness. As the result, Section 108 of the Code now applies only to situations in which the taxpayer is insolvent or in bankruptcy at the time of the discharge of indebtedness. The question presented in this case thus lacks any recurring importance to the administration of the tax laws.

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* Petitioner acknowledges (Pet. 16-17) that Section 988 was designed to reverse the result of the decision of the Sixth Circuit in *Kentucky & Indiana*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

1. Section 108 of Title 26 of the United States Code (1982) provided, in relevant part:

(a) **Exclusion from gross income**

(1) **In general**

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent, or

(C) the indebtedness discharged is qualified business indebtedness.

* * * * *

(c) **Tax treatment of discharge of qualified business indebtedness**

In the case of a discharge of qualified business indebtedness—

(1) **Basis reduction**

(A) **In general**

The amount excluded from gross income under paragraph (C) of subsection (a)(1) shall be applied to reduce the basis of the depreciable property of the taxpayer.

(B) **Cross reference**

For provisions for making the reduction described in subparagraph (A), see section 1017.

* * * * *

(d) **Meaning of terms; special rules relating to subsections (a), (b), and (c)**

* * * * *

(4) **Qualified business indebtedness**

Indebtedness of the taxpayer shall be treated as qualified business indebtedness if (and only if)—

(A) the indebtedness was incurred or assumed—

(i) by a corporation, or

(ii) by an individual in connection with property used in his trade or business, and

(B) such taxpayer makes an election under this paragraph with respect to such indebtedness.

* * * * *

2. Section 1017 of Title 26 of the United States Code (1982) provided, in relevant part.

(a) **General Rule**
If—

(1) an amount is excluded from gross income under subsection (a) of section 108 (relating to discharge of indebtedness), and

(2) under subsection (b)(2)(D), (b)(5), or (c)(1)(A) of section 108, any portion of such amount is to be applied to reduce basis,

then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

* * * * *